# THE PERVASIVE INFLUENCE OF ECONOMIC ANALYSIS ON LEGAL DECISIONMAKING

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## I. INTRODUCTION

Judge Richard Posner claims that the application of economic analysis to legal issues may be "the most important development in legal thought in the last quarter century."[1] Certainly the ability to use economic analysis as a mechanism for conceptualizing legal problems has made an enormous impact on legal academia. In particular, the application of economic analysis to legal issues has had a substantial impact on our ability to *understand* cases. The critical and unanswered question, however, is whether the application of economic principles to legal issues has had any effect on the *outcomes* of cases. Put another way, Posner and others in the Law and Economics Movement (including muself) who champion the use of economic analysis in judicial decision-making have not confronted the question of the proper relationship between economic and legal analysis. After all, if one begins with the premise that the law should reach efficient outcomes, then one must confront the question of why economic reasoning should not displace legal reasoning as the principal method by which legal rules are formulated and evaluated by common-law judges.

My thesis is that, despite the massive attention that has been given in the literature to the economic analysis of law, the Law and Economics Movement has had little effect on the methodology by which cases are decided. Ironically, there is an economic explanation for the fact that traditional common-law reasoning continues to dominate the judicial decision-making process. The argument is simple. Economic reasoning has not replaced legal reasoning because traditional legal analysis provides a more *efficient* method for deciding cases than does modern economic analysis.

Moreover, I will argue that traditional legal reasoning in many areas of the law is not appreciably different from economic reasoning. The rhetoric is different, of course, but the analysis is the

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1. RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW xix (3d ed. 1986).

same. Finally, I will argue that the analysis in this article has important implications for the use of economic analysis in resolving disputes. I will show that economic analysis is a substitute for traditional analysis. Traditional legal analysis continues to dominate economic analysis in resolving disputes because it is more efficient.

This article uses economic analysis to explain why legal reasoning dominates economic reasoning as a methodological tool for deciding cases, and to explore some of the implications of this insight. The article proceeds in three parts. In Part II, I discuss the differences between legal and economic reasoning. In Part III, I explain the efficiency characteristics of legal and economic reasoning to explain why it is efficient for the former to dominate the latter in judicial decision-making. Finally, in Part IV I discuss the role of economic analysis in a world where legal reasoning is more efficient than economic reasoning.

## II. Legal Reasoning and Economic Reasoning

Commentators generally fail to understand that legal reasoning and economic reasoning simply employ different methodologies to deal with the same problem and achieve similar goals. This common problem concerns the question of how to allocate resources and responsibilities in a society characterized by constant conflict and scarcity. The two recurring themes in both legal and economic reasoning concern how to create appropriate incentives to guide the people who are subject to a particular set of legal rules into reaching efficient outcomes. Efficiency is traditionally defined as the state of affairs that exists under which no changes can be made to improve the condition of one person, or group of people, without diminishing the condition of another person or group.

The difference between economic and legal reasoning is that economic reasoning attempts to deal with issues like incentives and efficiency directly, while legal reasoning rarely uses these terms explicitly. Instead, judges generally employ looser, more general terms like "justice," "fairness," and "equity" to explain their reasoning. Despite these rhetorical differences, however, economic concepts dominate legal reasoning.

The implicit use of economic concepts in legal reasoning is quite obvious in some contexts. For example, in *United States v.*

*Carroll Towing Co.*,[2] Judge Learned Hand was faced with the most basic issue in the law of torts; namely, the standard to be applied in a lawsuit alleging negligence. The economic problem here results from the fact that the benefits of preventing accidents must be balanced against both the costs of employing safety precautions and the probability of an accident occurring. It makes little economic sense to spend $100 to prevent an accident that will cause $100 in damage, if there is only a two percent chance that the $100 in damage will ever occur. The negligence formula devised by Judge Hand in *Carroll Towing* reaches the efficient result. The case involved a vessel that broke away from its moorings. Without mentioning the economic goals of efficiency or incentive creation, Judge Hand opined that:

> Since there are occasions when every vessel will break from her moorings, and since, if she does, she becomes a menace to those about her; the owner's duty, as in other similar situations, to provide against resulting injuries is a function of three variables: (1) The probability that she will break away; (2) the gravity of the resulting injury, if she does; (3) the burden of adequate precautions. Possibly it serves to bring this notion into relief to state it in algebraic terms: if the probability be called P; the injury, L; and the burden, B; liability depends on whether B is less than L multiplied by P, i.e., whether $B < PL$.[3]

Proper application of the Hand Formula will lead to efficient risk-taking. Precautions against injury are only required where the marginal benefit of taking precautions outweighs the marginal costs. This creates the appropriate incentives for all economic actors. Interestingly, a judge with no formal training reached the economically correct result using common-law reasoning processes instead of economic analysis. Moreover, as Posner has observed, judges have been reaching the economically correct results in tort cases ever since the doctrine of negligence was introduced.[4]

Here it is obvious that economic reasoning and legal reasoning not only produce the same results, but also involve the same analysis, albeit with different nomenclatures. This is also true in fields like antitrust, where economic analysis has explicitly become part of the law. Yet the analysis also holds true in fields such as con-

2. 159 F.2d 169 (2d Cir. 1947).
3. *Id.* at 173.
4. *See* Richard A. Posner, *A Theory of Negligence*, 1 J. LEGAL STUD. 29 (1972).

tracts, property law, and criminal law, where the use of economic analysis by judges is less obvious.

The relationship between economic analysis and the law of contracts is obvious. Economic analysis emphasizes the fact that exchanges should be encouraged because they benefit contracting parties by allowing goods and services to be transferred to higher-valuing users. These benefits to the contracting parties result from the fact that exchanges allow people to obtain assets that they value more highly than the assets they have given up. Society benefits through this process by increasing employment and providing people with incentives to be productive. The economic function of the law of contracts is to encourage exchanges by fashioning a set of fixed and clear legal rules to reduce the transaction costs that burden the contracting process.

Because information is costly to acquire, and future contingencies are difficult to anticipate, parties will not find it cost-effective to specify their respective rights and obligations completely when they enter into contracts. The basic purpose of contract law is to fill the gaps in the contracts that people make, by "reproduc[ing] what the parties would have agreed to if they could have costlessly planned for the event initially."[5]

Thus, for example, in *Canadian Industrial Alcohol Co. v. Dunbar Molasses Co.*,[6] the plaintiff had contracted to purchase "approximately 1,500,000 wine gallons Refined Blackstrap [molasses] of the usual run from the National Sugar Refinery, Yonkers, N.Y."[7] The defendant was an intermediary, who was to purchase the sugar from the National Sugar Refinery and deliver it to the plaintiff in Canada. Unfortunately for the plaintiff, the National Sugar Refinery produced only 485,848 gallons of syrup; far less than was expected. This under-production caused the defendant, Dunbar Molasses Company, to breach the contract. In deciding the case Judge Cardozo, writing for the New York Court of Appeals, inquired into the allocation of risk among the parties:

> The defendant does not even show that it tried to get a contract from the refinery during the months that intervened between the acceptance of the plaintiff's order and the time when shipments were begun. It has wholly failed to relieve itself of the imputation of contributory fault. *So far as the record*

5. A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 27 (2d ed. 1989).
6. 179 N.E. 383 (N.Y. 1932).
7. *Id.* at 397.

> *shows, it put its faith in the mere chance that the output of the refinery would be the same from year to year, and finding its faith vain, it tells us that its customer must have expected to take a chance as great.* We see no reason for importing into the bargain this aleatory element. The defendant is in no better position than a factory who undertakes in his own name to sell for future delivery a special mill. The duty will be discharged if the mill is destroyed before delivery is due.[8]

In other words, the parties failed to specify *ex ante* who should bear the risk of this particular contingency: a diminution in production by the National Sugar Refinery. Reasoning from structure and relationship, however, the court decided that the parties must have expected that the defendant would bear this risk. First, the court noted that the plaintiff could have contracted directly with the National Sugar Refinery but declined to do so. Moreover, the court noted that the defendant could have eliminated its risk by entering into a contract with the refinery after it had reached its agreement with the plaintiff. Clearly the plaintiff would have gotten a windfall if the price of syrup had declined precipitously. Thus, by parity of reasoning, the plaintiff should have borne the risk on the down-side as well, suffering as a result of the diminution in supply. This result is efficient and perfectly consistent with economic principles, although no reference to economic analysis is made anywhere in the opinion.

Other aspects of legal reasoning in contract law similarly involve efficiency criteria. For example, in *Bach v. Long Island Jewish Hospital*,[9] an emancipated infant contracted to have cosmetic surgery and then attempted to disaffirm her consent after the operation was performed. The court held that the infant had received the full benefit of her bargain and would not be permitted to avoid payment. This result is efficient because it prevents contracting parties from acting opportunistically by contracting and then reneging on the contract based on a pre-existing condition known to them at the time. A contrary result in such cases would reduce societal welfare by denying all emancipated infants the opportunity to enter into beneficial exchanges. Similarly, contractual problems involving such disparate issues as nonsimultaneity of performance, coercion, fraud, mistake, and dam-

8. *Id.* at 199-200 (citations omitted) (emphasis added).
9. 267 N.Y.S. 2d 289 (Sup. Ct., Nassau County, 1966).

ages all have been resolved by judges in ways fully consistent with economic principles.[10]

The economic principles utilized in property law are also designed to maximize societal wealth. Indeed, market exchanges, a critical feature of a market-oriented economic system, would not be possible without private property. Just as contract law facilitates bargaining by establishing the ground rules for exchanges, property law facilitates bargaining by establishing the contours for legal entitlements, thereby creating incentives to use resources efficiently.[11]

*Fountainbleau Hotel Corp. v. Forty-five Twenty-five Inc.*,[12] presents a striking example of the symbiotic relationship between economic and legal principles. Two neighboring hotels enjoyed views of the Atlantic Ocean and the promise of lots of Florida sunshine for their guests. The Fountainbleau proposed to add a significant addition to its main building in the form of a 14-story tower that would extend 130 feet above grade. This addition would enshroud the cabana, swimming pool, and sunbathing areas of the Eden Roc in shade every afternoon.

The court dismissed Eden Roc's complaint on the ground that, absent a statutory or contractual obligation, it had no legal right to the free flow of light and air from the adjoining land so long as the obstruction being constructed "serves a useful and beneficial purpose."[13] This case presents a straightforward application of the Coase Theorem: Absent transaction costs, parties will bargain for an efficient allocation of property rights irrespective of the initial allocation of such rights by the legal system.[14]

There are three economic issues underlying the simple fact pattern in the *Fountainbleau* case. The first concerns the question of the efficient allocation of property rights as between the Fountainbleau and the Eden Roc. In order for the outcome to have been efficient, the increase in value to the Fountainbleau from the construction of the addition must have been greater than the diminution in value to the Eden Roc. If this was the case, the court reached the efficient outcome. On the other hand, if the diminution in value to the Eden Roc was greater

10. *See* POSNER, *supra* note 1, at 79-125.
11. *Id.* at 30.
12. 114 So.2d 357 (Fla. Dist. Ct. App. 1959).
13. *Id.* at 359.
14. RONALD H. COASE, THE PROBLEM OF SOCIAL COST, 3 J.L. & ECON. 1 (1960).

than the increase in value to the Fountainbleau, the result reached was inefficient.

However, consistent with the Coase Theorem, the allocation of property rights by the courts would not have prevented the parties from reaching an efficient outcome. This is because the Eden Roc simply could have paid the Fountainbleau to decline to proceed with its proposed addition. Thus, the second economic issue in the case concerns the transaction costs that must be overcome by two firms in order for them to bargain to an efficient outcome. In *Fountainbleau,* the costs do not appear to have been high.

In this regard, it is interesting that a complaint was ever filed in this case in the first place. Clearly, Eden Roc must have thought that it had at least some small chance of winning its lawsuit, or it never would have commenced litigation. This litigation represented a waste of real resources, which would not have occurred if the legal rules had been clear. Thus, in this respect, the *Fountainbleau* case represents a failure of the legal system, albeit a small one.

The final economic issue in this case concerns the problem of strategic behavior. Suppose that, instead of constructing an addition to its hotel, the Fountainbleau proposed simply to erect a giant tower—whose sole function was to block the Eden Roc's view—just to extract a side payment from Eden Roc in exchange for Fountainbleau's agreement not to construct the tower. In such a context, a court's function would be to prevent strategic behavior. The court in *Fountainbleau* did this by requiring that the structure being built had to serve a useful and beneficial purpose.

From these three economic issues follow three economic lessons to be learned from *Fountainbleau.* First, economic analysis, in the form of the Coase Theorem, shows that to reach an efficient allocation of resources, there is no need for courts to inquire into which party to a lawsuit most values the assets in dispute, at least where private bargaining is possible. Second, the court does have an important role to play. This role consists of articulating clear legal rules that the parties can use as a background to support their bargaining. Finally, the *Fountainbleau* case shows that the courts have an additional role to play in property rights litigation. This role consists of reducing the incidence of opportunistic behavior in society by making sure that people

do not engage in activities designed simply to extort side-payments from other parties.

## III. The Efficiency of Legal and Economic Reasoning

The purpose of the above discussion has been to provide some insight into the relationship between legal and economic reasoning. As noted, legal analysis, like economic analysis, is concerned with the allocation of rights and responsibilities in society. This insight is more controversial than it may first appear. Generally, advocates of the Law and Economics School have assumed that economic analysis is a *complement* to legal analysis. By contrast, it would appear that, in many contexts, economic analysis is a *substitute* for legal analysis. In this regard, using both economic and legal analysis to solve the same problem might be wastefully duplicative. In such situations, the task is to determine which methodology is more efficient at problem-solving. Here I will argue that it is clear that traditional legal analysis is more efficient at legal problem-solving than is economic analysis. As a science, economics is primarily concerned with posing questions, devising theories, and testing hypotheses. While this process of formulating questions is interesting and important, economic analysis does not purport to supply answers to discrete legal problems.

First, as any economist will tell you, information is costly to produce. The high costs of producing information require that lawsuits often will be decided on the basis of incomplete information. For example, suppose that a court is trying to determine whether a particular criminal defendant is innocent. One type of error consists of letting a guilty person go free. The other type of error consists of convicting an innocent person. There is a trade-off involved in choosing between these two types of error. By setting high standards of proof, we can reduce the chances of the second type of error, but we will increase the incidence of the first type. Similarly, by lowering the evidentiary standards, we reduce the first type of error at the expense of the second. This, of course, will result in additional guilty persons going free. Economic theory can elucidate the problem, but it does not help us choose what standard of proof is best. Ultimately, the legal standard to be used requires a value judgment based on the costs of incorrectly rejecting the null hypothesis (that is, the hypothesis that the defendant is innocent). Economic analysis is not particularly useful in reaching this value judgment.

In other words, economic theory cannot supply the value judgments necessary to implenent its own insights. The legal system must do so, and it does. In addition, information problems in the real world often make it impossible to supply the quantitative information necessary to implement other insights. For example, as noted above,[15] in deciding a simple negligence case, a judge must estimate not only the amount of damage caused by the defendant, but also what it would have cost the defendant to prevent that damage, as well as the *ex ante* probability that the accident would occur. While it might be possible to quantify these calculations with more specificity than is currently done, it would be costly to do so. The additional estimation costs might not be worth the benefits, which come in the form of more efficient behavior by both defendants and plaintiffs. Economic theory itself explains why it is not desirable to require that such costs be incurred. Economic analysis indicates that the parties to a negligence action should devote resources to the litigation until the marginal benefits from such expenditures just equal the marginal costs. Thus, the parties themselves will spend the efficient amount of money to establish their cases without government coercion.

Statutes of limitation provide a good example of the way that the legal system responds to information problems. These statutes prevent people from bringing lawsuits after a certain amount of time has expired. Thus, as Posner has pointed out,[16] the statutes reduce the error costs associated with the use of stale evidence. Statutes of limitation are useful where the parties to legal disputes do not internalize all of the costs of bringing litigation. Because litigation may not be fully priced, statutes of limitation serve as a crude but effective mechanism for rationing inefficient disputes.

The most important reason that economic analysis has not replaced legal analysis in the judicial process is that legal analysis often is a more efficient mechanism for resolving disputes than economic analysis. Ironically, the (marginal) cost-benefit analysis that characterizes much economic analysis generally does not consider the costs associated with the analysis itself. By contrast, legal analysis is overwhelmingly concerned with these costs. Issues ranging from burdens of proof in trials, lengths of statutes

15. *See supra* notes 2-3 and accompanying text.
16. POSNER, *supra* note 1, at 554.

of limitations, the imposition of legally mandated "reasonable person" standards for evaluating defendants' conduct, and the state statutes of frauds in contract law all can be explained as legal devices for economizing on information costs.

The most significant way that the legal system economizes on information costs involves the use of such legal inventions as precedent and the canons of statutory construction in legal decisionmaking. Absent information costs, these doctrines are difficult to explain. This is because in the absence of information costs, judges simply would decide each case in such a way as to reach an efficient result. High information costs, however, make it difficult for judges to do this. Reliance on the canons of statutory construction and prior precedent allows judges to reach decisions in cases involving areas of the law in which they have little or no substantive expertise.[17] Economic science, on the other hand, provides no similar mechanism by which economists specializing in labor economics could decide cases involving principles of, say, corporate finance.

Put another way, such techniques of legal reasoning as interpreting statutes in the Hart and Sacks tradition[18] and applying traditional rules regarding the use of judicial precedents allow judges to reach efficient outcomes in legal disputes without mastering *either* the economics or the substantive legal rules relating to a dispute. By contrast, if judges attempted to decide cases using economic analysis, they would have to familiarize themselves with an astonishing number of highly specialized disciplines in addition to basic microeconomics. These additional specialties include econometrics, corporate finance, labor economics, industrial organization, and public choice, to name a few.

## IV. The Role of Economic Analysis in Legal Decisionmaking

Thus, ironically, the application of basic economic principles to the process of judging may indicate that, as the world becomes more complex, decisionmakers need to economize the process of judging. As economics becomes more specialized, its relevance

17. *See* Jonathan R. Macey & Geoffrey P. Miller, *The Canons of Statutory Construction and Judicial Preferences*, 45 Vand. L. Rev. 647, 660-61 (1992).

18. For a discussion of how judges reach efficient outcomes in cases involving statutory interpretation using the Hart and Sacks approach to cases, see Jonathan R. Macey, *Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model*, 86 Colum. L. Rev. 223 (1986).

to judicial decision-making is likely to decline, not increase. By contrast, the use of legal decision-making strategies such as *stare decisis* and the canons of statutory construction, which economize on information costs, is likely to increase as decisionmaking becomes more complex. Of course, in high stakes cases, it will pay for the parties to employ experts; but their task will be to inform laymen-judges, and not simply to converse with equally sophisticated economist-judges.

## V. Conclusion

Economics involves the study of markets. In many respects, the legal system is nothing other than a market in which the state creates rights and entitlements that parties can use to facilitate bargaining. Economic analysis can do a great deal to improve our understanding of the way that the market for legal rules works, but it is of only limited use in actually deciding cases. Thus, judges trained in traditional legal analysis need not worry that they will be replaced by economists.

Judge Posner has written that "[i]t would not be surprising to find that many legal doctrines rest on inarticulate gropings toward efficiency."[19] This article indicates that it is inaccurate to call common-law judicial doctrines inarticulate. Judges simply use a different mode of discourse than do economists to accomplish precisely the same ends. Thus, Posner's description of judges as inarticulate misses the point that judges simply are speaking a different language than economists. Both judges and lawyers attempt to achieve what economists would call efficient outcomes. Judges and lawyers speak in terms of justice, equity, and fairness rather than efficiency. Yet these terms produce results that correspond to economists' ideas of efficiency. Furthermore, the methodology employed to reach these results is highly efficient, because it economizes on information costs. That is why legal reasoning dominates economic reasoning in our legal system.

19. Posner, *supra* note 1, at 21.